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Behavioral Science Lessons From the Wells Fargo Scandal: Devil in the Decentralization (Part Two of Three)

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In early 2016, Wells Fargo had a sterling corporate reputation. Its massive retail arm (the Community Bank), was one of the most profitable entities in the world, and its management believed that the bank's employees were happy, properly incentivized and acting appropriately. Yet under that veneer, toxic micro-cultures and compliance gaps were breeding practices that would eventually cost the bank tens of billions of dollars in fines and lost market value. The 2016 Wells Fargo scandal demonstrates clearly that although a few bad apples in an organization can be problematic, systemic corporate compliance and ethics failures are largely a result of the conditions of the barrel, not the apples inside.

The first article in this three-part series described the scandal and discussed why Wells Fargo's extensive control infrastructure was insufficient to prevent such pervasive misconduct. In this second article, we will apply the principles of behavioral science to the facts of the case to demonstrate how everyday biases can lead to wide-spread misconduct. Specifically, we will show how conformity bias, issue framing and motivated reasoning may have led Community Bank employees to rationalize their own unethical behavior and fail to recognize unethical behavior in others, which ultimately fueled the systemic compliance breakdown at Wells Fargo. Our third article will provide practical advice for organizations seeking to apply these lessons in their own ethics and compliance programs.

See "When Every Employee Is a Keeper of the Company's Culture: An Interview With WD-40 Company's Karla Pinckes" (Jun. 13, 2018).

Conformity Bias and the Fallacy of Bad Apples

Social science research going back decades has taught us that people establish personal standards of ethical behavior largely by observing how those around them behave. The theory of normative conduct, for example, proposes that these behavioral perceptions provide a "cognitive shortcut" that guides our decision-making. In other words, if we observe that those around us are behaving a certain way, we are wired to conclude that the behavior is appropriate, or even expected, without ever actually giving the question any critical thought. These perceptions of group norms come in two types: descriptive norms (our perception of what is common, or normal behavior), and injunctive norms (our perception of what behavior is acceptable or unacceptable, from the perspective of others). Furthermore, recent research has shown us that what we perceive as a "normal" behavior is remarkably context-specific, quite changeable and not nearly as morally driven as we'd like to think.

The In-Group/Out-Group Effect

Conformity bias is an extension of this concept, and theorizes that an individual's propensity to follow the crowd depends largely on how closely they associate themselves with the group being observed. Intuitively, when our association with a particular group is strong, then we are much more likely to mimic the group's behavior than vice-versa. Subsequently, as a method of maintaining or enhancing our self-esteem, we become motivated to rationalize an unethical act committed by an in-group member as a descriptive norm (i.e., "it's not a big deal because everyone does it"), as opposed to simply judging it as an injunctive norm, as we would likely do if we witnessed the same behavior from an out-group member. An example of this can be seen in individuals with strong political ties who freely excuse or minimize unethical behavior, such as infidelity, by politicians associated with their favored party, but condemn the same behavior in politicians of a rival party.

This "in-group/out-group" effect can be so strong that unethical behavior can even be contagious, if the peer group association is strong enough. This concept was demonstrated in a 2009 laboratory study that asked a group of university students to solve a complex set of math problems and promised to pay them for correct answers. However, the research team purposefully made the test far too difficult for anyone to realistically complete in the allotted time. Knowing that it was virtually impossible to finish the test, the team then embedded a paid actor among the students and directed him to stand up within the first minute of the test and announce to the room that he had solved everything correctly. Despite the fact that everyone involved knew this to be impossible, the researchers congratulated the actor, who proudly accepted his money and left the room.

The remaining students, having witnessed a fellow student blatantly cheat without consequences, then predictably cheated significantly more (114% more) than the control group. This in and of itself is not exactly groundbreaking, however the researchers then added a twist to the experiment. For subsequent groups they outfitted the cheating actor in the t-shirt of a rival university. In those cases, the students cheated only 3.2% of the time, despite having the same monetary incentives. Like the politicos, the students both rationalized and mimicked the unethical behavior of the in-group member, while critically judging and rejecting the behavior of the out-group member. The results were a clear demonstration of how ethical choices are rarely a rational evaluation of costs and benefits, but rather influenced by biases and preferences of which we are seldom even aware.

A final twist to the experiment sheds more light on the topic. Using the same essential setup, instead of blatantly cheating, before beginning the test the actor conspicuously asked the proctor whether they could get away with cheating on the test. The proctor responded: "You can do whatever you want." The purpose of the exercise was simply to nudge the students to consider whether they intended to behave ethically or unethically once they began the test. When primed in this way, the students cheated significantly less than the in-group and control group. In other words, the experiment showed that simply considering the ethical aspect of a decision upfront can increase honesty.

The Devil in the Decentralization

These experiments, along with many similar and related ones, demonstrate the fallacy of thinking in terms of bad apples versus good apples when it comes to organizational ethics and compliance. In reality, most people's ethical standards exist on a sliding scale that can change drastically depending on context, particularly when group associations are at play. Given this, how does conformity bias help explain the misconduct that only 1% of Wells Fargo employees were implicated in? After all, if 99% of employees were behaving ethically at any given time, the inference should be that Wells Fargo's "descriptive norm" was ethical banking. For the Community Bank however, the devil was in the decentralization.

When Wells Fargo merged with Norwest Bank in 1998, it adopted a decentralized "run-it-like-you-own-it" management structure, which gave individual business lines autonomy over staff and control functions, such as risk and human resources. This effect was compounded by a period of massive expansion for the bank, during which it acquired 119 companies in nine years, including 10 bank holding companies, two large mortgage companies and the recently-failed Wachovia Financial.

In terms of enterprise-level compliance, this expansion and decentralization of entities under the Community Bank umbrella created a unique challenge. From the perspective of the rank and file, the bank's compliance tone was set locally, not at the top. In effect, decentralization allowed local managers to create multiple micro-cultures, some of which were toxic and drove unethical behavior. This is demonstrated in an independent report that the Wells Fargo's board of directors commissioned in an attempt to understand the root causes of the scandal (Independent Board Report). There, forensic analysis identified key "epicenters" of fraud within the Community Bank, all of which were overseen by regional managers who would later be tied to questionable management and incentive practices. "[B]ad practices tended to disproportionately cluster" in these areas.

Unethical Micro-Cultures

Within these epicenters, we see the evidence of conformity bias. Although data is limited, anecdotally speaking, the micro-cultures that went bad seemed to be near-total failures. News reports and subsequent investigations feature stories from employees within the most problematic areas, many of which point to conformity bias. Quotes such as "all the tellers and staff knew it," "everyone at the branch was aware," and "it was normal business practice" were common. Group mindset can also be inferred from the fact that the participants went so far as to give nicknames to the various types of common fraudulent acts – "gaming," "pinning," "sandbagging" and "bundling" were all part of a shared lexicon that in and of itself implies the existence of an in-group.

Another common element in these failed micro-cultures was that employees were under extreme pressure to sell. As noted in the Independent Board Report:

> Senior bankers [in these epicenters] were particularly associated with extreme pressure, in some cases calling their subordinates several times a day to check in on sales performance and chastising those who failed to meet sales objectives. Certain managers also explicitly encouraged their subordinates to sell unnecessary products to their customers in an effort to meet the Community Bank's sales goals.

The Independent Board Report concludes that intense sales pressure within the epicenters of fraud was ubiquitous, citing a "relentless focus on sales, abbreviated training, and high employee turnover." We think it is equally probable that this "relentless pressure," combined with the perception of being treated unfairly by upper management, may have created in-group bonds between employees in the affected branches, making cheating easier to rationalize within those groups. In addition, corporate leaders should take note of how decentralization of Wells Fargo's compliance culture made it possible for a few epicenters of unethical behavior to develop and have an outsized negative impact on the organization.

See "DOJ Steers the Compliance Conversation Toward Culture" (Apr. 18, 2018).

Issue Framing and Nudges in the Wrong Direction

When Wells Fargo first became aware of sales misconduct in 2004, it immediately began to fire people. The bank instituted a sales integrity task force with updated training, and made what the Independent Board Report described as "good faith efforts" to curb misconduct. History proves these efforts did not go far enough. Terminations for misconduct continued to rise steadily until the story broke in 2016, when the board of directors found out for the first time that over 5,300 Community Bank employees had been fired in the preceding five years for sales gaming. How was it that robust policies, monitoring, training and strict consequences for misconduct did not address the sales gaming problem? We believe a major reason is the way the issue was framed internally.

We have long known that the labels we use have a significant impact on the way we conceptualize choices. "Framing" is the act of prompting an observer to view an issue from a limited perspective. A psychological frame "manipulates salience," inviting an observer to focus on certain aspects of an object, and ignore everything that lies outside the frame. Framing can be a massively influential tool, and is a central component of commercial marketing, political campaigning and pretty much any other type of advocacy.

Fraud by Any Other Name

How did Wells Fargo fail in framing its fraud issue? To start, by not calling it fraud. Internally, Wells Fargo used a catch-all term – "sales practice misconduct" – which included activities that impact customers, such as forging a signature to open an unauthorized account, as well as non-customer related activities, such as reassignment of sales credit. This not only made it more difficult to highlight customer-facing fraud, but more importantly, shows that Wells Fargo did not consider the distinction between internal and external misconduct in the first place. Similarly, when a banker opened an unauthorized account and a customer reported it, it was labeled as "customer mismatch" or "slippage," as opposed to fraud, theft or misappropriation.

In their influential book, Nudge – Improving Decisions about Health, Wealth and Happiness, Richard Thaler and Cass Sunstein suggest undesirable behaviors can be "nudged" toward a better option by seemingly minor alterations to the "choice architecture," or context, in which the choice takes place. For example, it has been shown that placing healthy food at eye level in school cafeteria lines can nudge students into healthier lunch choices. In the case of Wells Fargo however, we would argue that employees were inadvertently nudged in a way that made it easier for them to rationalize cheating.

By using morally neutral language such as "customer mismatch" and "slippage," Wells Fargo invoked a policy-and-procedure approach, as opposed to a values-based approach to an ethical problem. This likely limited the "frame" through which the sales misconduct would be viewed by the business. For Community Bank employees, instead of being primed to consider a dilemma of personal-gain versus personal-integrity, which would reflect on their character, they were primed to consider personal gain versus compliance with corporate sales policies. This very likely could have made cheating much easier to rationalize, particularly for those employees who believed the sales policies were unfair to begin with.

Leaving Customers Out of the Frame

The second failure of framing was Wells Fargo's tendency to view the issue internally, instead of externally where the real risk lay. In fact, when defining the issue, Community Bank leadership seemed to leave the customer out of the frame altogether. The Wells Fargo Independent Board Report noted that "insufficient regard was paid to the effect of the violations on customers. When individuals were terminated for sales practice violations . . . the potential effect on customers was not regularly assessed . . . and perhaps more importantly, the Community Bank did not consider non-financial harm to customers resulting from the misuse of personal information or the opening of accounts in their names without their authorization."

While there are certainly anecdotal stories of employees expressing an awareness of customer impact, across the organization, it is clear that the problem was framed as an internal issue – i.e., an incentives and compliance issue between management and employees – as opposed to an ethical issue between Wells Fargo and its customers. We believe this failure in framing the misconduct as a customer-centric issue contributed to the scandal at every level. Because Wells Fargo defined the problematic practices as an internal compliance issue, the employees may have been nudged into believing the victim of their fraud was the bank (because they were getting commission on sales which were typically not profitable for the bank), as opposed to the customer, whose trust was being breached.

From leadership's perspective, framing the issue simply as an internal policy violation obscured the enormous reputational risk caused by the abuse of customer trust. Incredibly, Wells Fargo did not even consider the possibility that customers may have been impacted at all by account gaming until after they had already been sued by the City of Los Angeles in May of 2015. This is demonstrated by a statement made by CEO John Strumpf at his congressional hearing, after noting that initially the bank didn't realize customers could be charged fees for these fake accounts, he said, "when we finally connected the dots on customer harm in 2015, the board was very active on this."

In an insightful commentary on Strumpf's quote in the Harvard Business Review, Susan M. Ochs noted: "This statement implies that the only impact on consumers is monetary: wrongful fees. When the bank thought thousands of employees were simply violating consumer trust – stealing identities, forging signatures, secretly moving money – that wasn't enough harm to provoke the board's active involvement. This misjudgment . . . could explain why the board got engaged so late in the process. . . . Senior leaders were so focused on financial impact that they couldn't see the ethical damage."

See "Ian Hawkins of NBCUniversal on How Nudge Theory Can Improve a Compliance Program" (Jul. 25, 2018).

Failing to See the Fraud for What It Was

One of the most difficult aspects of the Wells Fargo scandal to understand is how senior management could be blind to the gravity of the risk they faced once the sales misconduct issue was brought to their attention. According to Strumpf's congressional testimony, the risk management committee of the board of directors became aware of significant allegations of sales misconduct in 2011. Strumpf himself was personally made aware in 2013, after it came to light that employees were continuing to be fired at the rate of approximately 1,000 per year despite the bank's remediation and training efforts. It was not until late in 2016, after a myriad of fines, media reports and a blistering congressional hearing that Wells Fargo leadership finally opted to make significant changes to its sales model.

Motivated Reasoning and Confirmation Bias

We believe that the science behind motivated reasoning and confirmation bias holds part of the answer to why it took so long for Wells Fargo executives to appropriately respond to the allegations of fraud.

Confirmation bias refers to our tendency to favor information that confirms our previously formed assumptions, beliefs or conclusions. Similarly, it describes our instinct to ignore or discount evidence that tends to disprove those beliefs. In fact, studies have shown confirmation bias has such a powerful influence on our cognition that we will continue to adhere to our pre-determined beliefs, even when there is concrete evidence showing that they are wrong, and even when holding onto those beliefs clearly costs us money, time or relationships. As Warren Buffett put it: "What the human being is best at is interpreting all new information so that their prior conclusions remain intact."

Motivated reasoning is a related theory that describes our tendency to accept as true conclusions that are favorable to our preferred world view, while viewing evidence that contradicts our preferred view with much more skepticism and critical analysis. Similar to confirmation bias, motivated reasoning is a mechanism for the brain to shape the world in a way that naturally makes sense to us, regardless of whether the shape is accurate. Psychologist Gary Marcus summarized the difference between the two concepts best: "whereas confirmation bias is an automatic tendency to notice data that fit with our beliefs, motivated reasoning is the complementary tendency to scrutinize ideas more carefully if we don't like them than if we do … Brains are designed to filter the world so we don't have to question it. While this helps us survive, it's a subjective trap; by only seeing the world as we want to, our minds narrow and it becomes difficult to understand opposing opinions."

Confirmation bias and motivated reasoning are powerful automatic responses that are wired into our brains in order to help us spot patterns and make sense of our surroundings. However, in situations that require critical analysis, they can also lead to overconfidence in our intuitive conclusions and doubling down on those conclusions when faced with contrary evidence. In the case of Strumpf, Tolstedt and other Wells Fargo leaders, this meant disregarding or viewing with great skepticism any evidence of systemic problems at the Community Bank and choosing to simply believe that nothing was wrong.

Overly Optimistic Executives

In exploring the root causes of the scandal, the Independent Board Report noted: "Strumpf was by nature an optimistic executive who refused to believe that the sales model was seriously impaired. His reaction invariably was that a few bad employees were causing issues, but that the overwhelming majority of employees were behaving properly. He was too late and too slow to call for inspection of or critical challenge to the basic business model."

For an objective eye, the data was there to see. Customer complaints, ethics-line reports and employee turnover in key areas rose steadily in the period leading up to the initial Los Angeles Times Report. Crucially, analytics showed a clear correlation between increases in sales goals and allegations of sales misconduct during this time. In addition, there was a similarly clear negative correlation between sales goals and the "funding rate" of Wells Fargo products, particularly in the previously identified epicenters of misconduct. In other words, from the period from 2011 through 2015, it was clear that as sales goals increased and became harder to achieve, employees began to cheat more, and as employees began to cheat more, Wells Fargo customers at large were being saddled with more and more products they weren't using.

All this data notwithstanding, senior leaders continued to display a confirmation bias toward metrics that supported their favored conclusion, particularly the 1% metric. In an email Strumpf wrote shortly after the filing of the Los Angeles City lawsuit:

> I really feel for Carrie [Tolstedt] and her team. We do such a good job in this area. I will fight this one to the finish. Do you know only around 1 percent of our people lose their jobs [for] gaming the system… Nothing could be further from the truth on forcing products on customers. In any case, right will win and we are right. Did some do things wrong — you bet and that is called life. This is not systemic.

When presented similar data in 2013, one senior executive wrote that it was "mind boggling to me it's so low – I think it shows our [employees] are significantly more ethical than the general population (no data whatsoever to back that up, just impressionistic comment!)."

In fixating on the 1% metric, senior leaders fell into the "subjective trap" Dr. Marcus described. They failed to consider, for example, that only 1% of employees were being caught because the bank was exceptionally bad at detecting sales misconduct, or whether 1% was truly acceptable given the degree of reputational risk involved. As a result, sales incentives remained unchanged, and the drive for gr-eight, the push for employees to sell eight products to every customer, continued.

In these examples we also see evidence of motivated reasoning; senior leaders seemed to take for granted the propriety of practices they supported, such as aggressive sales goals, and were highly critical or obstructive with regard to information that questioned those practices. For example, Carrie Tolstedt viewed aggressive sales goals as critical to Wells Fargo's success, and according to interviews, was "obsessed" with controlling information that cast the sales system in a negative light. In fact, by 2015, many board members believed that she was intentionally obfuscating and downplaying the extent of sales misconduct problems in the Community Bank.

Wells Fargo's head of risk, Claudia Russ Anderson, was similarly known to be highly critical of attempts to escalate concerns regarding sales practices, to the point where some on the board believed she was "running interference" for the business. In 2012, when the head of corporate security sought to escalate increases in confirmed fraud to senior leadership, Russ Anderson told him that his reporting made the problem sound "so much worse than it is." In response, he noted that Russ Anderson "often challenges the Audit, [Compliance Steering Committee and Board] reporting verbiage. It is often a classic case of minimizing the negative information being submitted to executive management."

Russ Anderson also persistently challenged data that showed that terminations related to sales misconduct were rising within the Community Bank, despite the fact that the head of Internal Investigations and members of the legal team had defended the accuracy of the data. Russ Anderson critically withheld this information from a 2015 Board meeting intended to specifically address sales misconduct, likely delaying significant remediation efforts.

In the end, Strumpf, Tolstedt and Russ Anderson would all lose their jobs, less for the toxic culture they helped create than for their inadequate response to the problem. This outcome can be traced directly to decisions that are near-classic examples of overconfidence due to confirmation bias and motivated reasoning.

See "Guide to Creating an Effective Compliance-Based Employee Incentive Program (Part One of Two)" (Jan. 7, 2015); Part Two (Jan. 21, 2015).

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